

BUSINESS AND OCCUPATION TAX  
RCW 82.04

Tax Base      Gross receipts (gross income, gross sales or value of products) of all businesses operating in Washington, as a measure of the privilege of engaging in business.

Tax Rate      Six different tax rates apply to various classifications of business activities. The current B&O tax rates are:

|   |        |
|---|--------|
| Manufacturing, wholesaling, and other activities* .....   | 0.484% |
| Retailing, environmental cleanup, and<br>radioactive waste cleanup for the U.S. ....  | 0.471% |
| Travel agents, stevedoring, & freight brokers,<br>international investment management services .....  | 0.275% |
| Processing meat (at wholesale); processing soybeans,<br>canola, & dry peas; manuf. wheat into flour; manuf.<br>raw seafood; warehousing/reselling of prescription drugs;<br>and manuf. fresh fruit, vegetables & dairy products ..... | 0.138% |
| Disposal of low-level radioactive waste .....   | 3.3%   |
| All services, public/nonprofit hospitals,<br>and all other activities .....   | 1.5%   |

\*Extracting, extracting and processing for hire, commissions of insurance agents/brokers, printing and publishing, child care, income derived from royalties, warehousing, radio and TV broadcasting, public road construction, government contracting and retailing of interstate transportation equipment.

Firms are taxable according to the activities they engage in and may be subject to more than one tax rate, depending upon the source of their income.

Four principal business sectors (based on standard industrial classification) account for over three-quarters of total B&O tax liability. In fiscal year 2000 manufacturing was responsible for 17.8 percent of the tax; wholesaling contributed 10.1 percent; retailing accounted for 15.1 percent; and services (including financial, insurance and real estate) produced 34.1 percent.

Levied by State (There is no statutory or administrative relationship between the state B&O tax and the gross receipts taxes levied by some cities.)

Recent Collections (\$000)

| <u>Fiscal Year</u> | <u>Collections</u> | <u>% Change</u> | <u>% of All State Taxes</u> |
|--------------------|--------------------|-----------------|-----------------------------|
| 2001               | \$2,012,403        | 8.5%            | 17.0%                       |
| 2000               | 1,854,948          | 1.5             | 15.7                        |
| 1999               | 1,827,459          | (1.4)           | 15.8                        |
| 1998               | 1,853,815          | 7.6             | 16.6                        |
| 1997               | 1,722,802          | 4.9             | 16.4                        |
| 1996               | 1,642,403          | 3.3             | 16.5                        |
| 1995               | 1,590,477          | 7.9             | 16.5                        |
| 1994               | 1,473,869          | 15.5            | 16.3                        |
| 1993               | 1,276,625          | 4.1             | 15.3                        |
| 1992               | 1,226,875          | 8.3             | 15.6                        |

Administration

Department of Revenue. Firms register with the Department by filing a Master Business Application (Form #BLS 700-028) with the Department of Licensing before they commence operation. The fee for the Master Business License is \$15 (\$20 if the firm is registering a trade name). The Department of Revenue assigns the applicant to monthly, quarterly or annual reporting frequency for state excise tax purposes depending upon the type and estimated level of business activity. Also, the firm is assigned to the appropriate industrial classification, based on the applicant's description of the firm's primary activity. The six-digit number reflects the North American Industrial Classification System (NAICS), an identification system used by the federal governments of the U.S., Canada and Mexico.

The B&O tax is reported on the combined excise tax return (Form #40 2406). The return for monthly reporters is due on the 25th of the following month; quarterly filers report by the end of the month following the close of the quarter; and annual taxpayers file by the end of January. Firms are encouraged to file their tax return and submit payment electronically by accessing the Department's webpage (<http://dor.wa.gov/elf/elfcontent.htm>).

Firms whose annual gross income does not exceed \$28,000 are relieved of the obligation to file excise tax returns, if they have no other state excise taxes to report (e.g. retail sales tax collected from customers).

Distribution of Receipts

State general fund, except the proceeds of the tax on public and nonprofit hospitals goes to the health care account.

## Exemptions, Deductions and Credits

The B&O tax is basically a tax on gross receipts with no deduction for costs of doing business, such as payments for raw materials and wages of employees. Nonetheless, there are many exemptions and deductions for specific types of business activities and certain tax credits permitted under the B&O tax statutes. Some of the major ones are summarized below.

### EXAMPLES OF EXEMPTIONS:

- income from sale or rental of real estate;
- operating income of public utilities (subject to public utility tax);
- international banking facilities;
- insurance premium income subject to the insurance premiums tax;
- production of agricultural/horticultural products at wholesale;
- commuter ride-sharing (vanpools) and nonprofit transportation of elderly/disabled;
- salaries and wages of employees (not considered as "engaging in business");
- fund-raising activities of nonprofit organizations;
- day care provided by churches;
- income of the American Red Cross;
- nonprofit sheltered workshops and group training facilities;
- credit unions;
- grants and income received by local governments (except for proprietary activities);
- direct sales by out-of-state firms via manufacturer's representatives;
- accommodation sales between firms that sell the same type of product.
- income of small timber harvesters who cut less than 2,000,000 board feet per year;
- health maintenance organizations (subject to insurance premiums tax);
- nonprofit blood banks.

### EXAMPLES OF DEDUCTIONS:

- network advertising & revenue from the out-of-state portion of radio/TV broadcasting;
- investment income of nonfinancial business and dividends of subsidiary firms;
- membership dues, contributions and donations, and tuition fees;
- cash discounts taken by purchasers;
- credit losses incurred by taxpayers who use accrual accounting;
- income represented by federal and state motor vehicle fuel taxes;
- income which the state constitutionally may not tax (e.g., interstate commerce);
- interest from first mortgage residential loans and certain agricultural loans;
- government bond interest;
- manufacturing completed in Washington (minor final assembly);
- reimbursed expenses of funeral homes;
- governmental grants for nonprofit social and health programs;
- municipal sewer charges to other governmental agencies;
- income of nonprofit artistic and cultural organizations;
- health insurance claims paid by insurance companies;
- fuel consumed outside territorial waters by commercial vessels;
- income from governmental sources (e.g., Medicare) received by public or private hospitals directly from the federal government or from contractual managed care entities.

## EXAMPLES OF CREDITS:

- a \$2,000 credit for each full-time job created by a manufacturing, research & development or computer firm in a rural county or community empowerment zone (\$4,000 for high wage jobs);
- \$3,000 credit for new employees of international service firms in certain locations;
- \$1,000 credit for new employees engaged in developing software in rural counties;
- extracting/manufacturing B&O tax liability of firms that sell the same products at wholesale or retail in Washington (multiple in-state activities credit);
- credit for investment in R&D equipment/facilities by certain high technology firms;
- gross receipts taxes paid in other states or countries;
- payments by employers for ride-sharing and commute trip reduction programs;
- small business tax credit of \$35 per month (phased out at \$70) for small firms;
- credit for income derived in rural counties from providing help-desk services;
- credit for public utility tax paid on purchases of natural gas by direct service industries (who purchase power directly from BPA) that construct a gas turbine facility to generate their own electrical power.

## History

The Business Activities Tax of 1933 (adopted as a temporary, emergency revenue measure) was a forerunner of the B&O tax which was included as part of the Revenue Act of 1935. The gross receipts form of business tax was upheld by the State Supreme Court in 1933 as an excise tax on the privilege of engaging in business. Initial rates of the B&O tax were 0.25 percent for all activities except services which were taxed at 0.5 percent. Subsequent rate increases were enacted via surtaxes in 1951, 1955, and 1959 which led to the current base tax rate of 0.44 percent for manufacturing, wholesaling and retailing activities. A surtax of 6 percent was applied from 1976 until 1979. In 1982 and 1983, a series of surtaxes were adopted, including four rate changes within a period of 15 months. These included a 10 percent surtax which became incorporated into the current permanent rate for the manufacturing and wholesaling classifications. Also, over the years a number of new rate categories, usually at lower rates, were created for specific business activities. In 1998, several of these were consolidated into the two rate categories of 0.275 percent and 0.138 percent.

In 1959, the Legislature attempted to extend the tax to income from the rental of real estate. However, the State Supreme Court ruled that the tax constituted double taxation, because the income was essentially derived from the real estate itself and this was already subject to ad valorem property taxation. In 1970 the tax was broadened to include financial institutions under the service classification.

From 1965 until 1971 a credit was allowed for manufacturers that invested in new facilities. Investments in qualified pollution control devices were allowable as a tax credit from 1967 through 1981 (previously approved credits may still be taken). A credit for an increasing percentage of the amount of personal property tax paid on business inventories was in effect from 1974 through 1983, until these became directly exempt from property tax.

In 1987 the U.S. Supreme Court ruled that the Washington B&O tax presented the potential for double taxation of the same income for manufacturing firms that do business in this and other states. In response, the Legislature adopted several credits: (1) for in-state firms that either extract or manufacture as well as sell at wholesale or retail, the firm is subject to tax under both the extracting/manufacturing classifications as well as the wholesaling/retailing classification, but the tax on production is creditable against the selling tax; and (2) for firms that produce or sell in both Washington and other states or countries, a credit for any similar taxes measured by gross receipts is allowed.

Major rate changes occurred in 1993. New classifications for business services and financial services were created and the rates for these, as well as the remaining general service and other classification, were increased. In 1997, all of the service activities were returned to a single rate category, and the rate was returned to the previous 1.5 percent. A surtax of 6.5 percent was applied to many of the B&O classifications, effective July 1, 1993 through June 30, 1997. The following year the surtax rate was reduced to 4.5 percent. Also in 1993, the deduction for payments received by nonprofit and government hospitals was repealed and a new tax classification was established at the 1.5 percent rate with the receipts dedicated to state health care programs.

A major change in the treatment of small business occurred in 1994 when the previous threshold of \$1,000 per month was replaced by a credit equal to \$35 per month for small firms, and a reduced credit for firms with tax liabilities up to \$70 per month. For example, a service firm pays no tax if income is less than \$28,000 per year ( $\$35/.015 \times 12$ ); a manufacturing firm does not incur B&O liability until it reaches income of \$86,777 per year ( $\$35/.00484 \times 12$ ). It is estimated that the small business credit now completely exempts from B&O tax liability about 92,700 firms and reduces taxes for an additional 34,000 firms.

In 1998 a significant reduction in the number of B&O tax categories was enacted. As a result of this and elimination of the separate service classifications for business and financial services, the number of tax rates has been reduced from 13 to six. The rate of 0.011 percent for wholesaling of grain was eliminated and the activity was exempted from tax. Several other activities were reclassified and consolidated into lower rate categories.

Also in 1998 the tax on internal distributions was repealed. Enacted in 1955, this tax had attempted to eliminate the preference enjoyed by integrated firms that distribute their products to two or more of their own outlets (for nonintegrated firms, B&O tax applies to distributional activities under the wholesaling classification).

### Discussion/Major Issues

As of July, 2001 there were about 580,600 firms registered with the Department for state excise tax purposes (excluding timber tax and excise taxes in lieu of property tax). However, many of the registered firms are temporarily inactive or are below the \$28,000 filing threshold and do not have a current tax liability. During fiscal year 2001 there were approximately 233,000 firms that reported B&O tax with taxable income subject to the tax.

The B&O tax is unique; no other state levies a comprehensive gross receipts tax on all businesses. Most other states rely upon a corporate net income tax, similar to the federal tax. Washington's B&O tax produces a much larger portion of total state revenues than do the corporate income taxes in most other states. As a result, the tax burden initially imposed upon business in Washington is relatively high compared with other states (especially when the share of the sales tax initially paid by businesses is considered).

The tax has several important advantages. It is easy to understand, simple to calculate for taxpayers and auditing is relatively uncomplicated. The complex determination of net income is avoided, and there is essentially no need to apportion income among states for most multistate operations. (In some instances service businesses may apportion their income, based on separate accounting or the cost of doing business in Washington and other states.) The tax is deductible for federal income tax purposes as a cost of doing business. There is no discrimination due to structure of the firm; corporations and noncorporate businesses are treated alike. Firms can project sales better than profits and therefore may be better able to include the tax in the prices they charge, if market conditions permit. It assures that profitable businesses and those organized as nonprofit, as well as unprofitable enterprises (including those that intentionally operate at low profit margins by paying abnormally high salaries to owners) pay some tax for the government services they enjoy. Economically, it encourages firms to operate with maximum efficiency. Finally, it is a very productive and stable revenue source for government; collections do not fluctuate during economic downturns to the same extent as other tax sources, such as the sales tax or a business tax based on profits.

Negative features of the B&O tax are significant. Most importantly, it imposes a heavy burden on new and small businesses that may not have reached their maximum level of operating efficiency, or have yet to fully develop their markets, and as a result are unprofitable. Thus, the tax does not encourage economic development. As a result, established profitable firms are favored at the expense of new, start-up businesses.

Because the tax does not consider profit, there is continual pressure on the Legislature to grant new preferential tax rates for industries that are in economic difficulty or are in a poor position to pass the tax along in their pricing structure. One of the state's major industries, agricultural production, is entirely exempt from the tax. The tax pyramids for sales to other firms at each level in the chain of production (e.g., manufacturing to wholesaling to retailing) and thus favors vertically integrated firms which are taxed only upon the income derived from the final sale of the product.

Finally, the tax favors low-volume, high-profit types of business activities. For example, compare the profit margins of two different service industries: legal services, with typical net profits before taxes of about 18 percent, and barber and beauty shops with an average of about 5 percent. Yet the applicable B&O tax rate is the same 1.5 percent for both. Thus, compared with profits for the firm, the effective B&O tax rate is only 8.3 percent for legal services but 30 percent for barber and beauty shops.